

UNITED STATES DISTRICT COURT
DISTRICT OF NEVADA

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In re SOUTH EDGE LLC,
Debtor.

MERITAGE HOMES OF NEVADA, INC.
and MERITAGE HOMES
CORPORATION,

Appellants,

v.

JPMORGAN CHASE BANK, N.A., et al.,

Appellees.

2:11-CV-01963-PMP-PAL

OPINION

Before the Court is Appellants Meritage Homes of Nevada, Inc. and Meritage Homes Corporation's (collectively, "Meritage") appeal of the bankruptcy court's Order Confirming Joint Plan of Reorganization ("Confirmation Order") for the Debtor, South Edge, LLC ("South Edge"). Specifically, Meritage challenges the Confirmation Order's approval of exculpation and post-confirmation injunction provisions. Meritage also challenges language in the Confirmation Order which states a Repayment Guaranty which Meritage executed is not satisfied or released through confirmation.

Appellees JPMorgan Chase Bank, N.A. ("JPMorgan"); and KB Home, Inc.; KB Home Nevada, Inc.; Toll Brothers, Inc.; Coleman-Toll Limited Partnership; Beazer Homes USA, Inc.; Beazer Homes Holdings Corp.; Weyerhaeuser Real Estate Company; and Pardee Homes of Nevada, Inc. (collectively, the "Settling Builders"), move to dismiss the appeal as

1 moot. (Appellees' Mot. for Dismissal of Appeal (Doc. #17).) JPMorgan and the Settling
2 Builders also oppose Meritage's appeal on the merits.

3 **I. BACKGROUND**

4 The following factual background is derived largely from the statement of facts
5 as recited by the bankruptcy court in the Confirmation Order and the Declaration of Cynthia
6 Nelson, Chapter 11 Trustee, in Support of Confirmation of the Plan of Reorganization, as
7 incorporated in the Confirmation Order. (AER Tabs 12, 17.) Debtor South Edge is a
8 limited liability company that owns a real estate development known as Inspirada. (AER
9 Tab 12 at ¶ 10.) South Edge was a joint venture by eight builders who are South Edge's
10 members: KB Home Nevada, Inc.; Coleman-Toll Limited Partnership; Pardee Homes of
11 Nevada; Beazer Homes Holdings Corp.; Meritage; Focus South Group, LLC; Alameda
12 Investments, LLC; and Kimball Hill Homes Nevada, Inc. (Id. at ¶ 12.)

13 To fund the Inspirada project, South Edge took out loans ("Prepetition Loans") in
14 the aggregate amount of \$585 million pursuant to a Credit Agreement under which
15 JPMorgan acts as Agent for the other prepetition lenders. (Id. ¶ 13.) As security for the
16 loans, JPMorgan and the other prepetition lenders obtained liens on virtually all of South
17 Edge's real and personal property. (Id.) Additionally, each South Edge member and its
18 respective parent signed guaranties in favor of JPMorgan as Agent under the Credit
19 Agreement. Specifically, each member and its respective parent signed a guaranty of the
20 completion of certain improvements on the Project (the "Completion Guaranty"), limited
21 guaranties for certain fraudulent or unlawful acts (the "Limited Guaranty"), and a guaranty
22 that the members and parents would be responsible for repaying South Edge's obligations in
23 the event of the voluntary or involuntary bankruptcy of South Edge (the "Repayment
24 Guaranty"). (AER Tab 15 ¶ 12.)

25 In the spring of 2008, work at Inspirada came to a halt as a result of the
26 insolvency of two of the builder members, disputes among the builder members, disputes

1 between the builder members and the prepetition lenders, and South Edge's default on its
2 obligations under the Credit Agreement. (Id. at ¶ 15.) The result has been a slew of legal
3 actions filed in this Court and elsewhere, including this involuntary chapter 11 bankruptcy
4 proceeding which some of the prepetition lenders initiated against South Edge. (AER Tab
5 9, Tab 15 at ¶¶ 19-25.) JPMorgan, as Agent for the prepetition lenders, moved for the
6 appointment of a bankruptcy trustee. The bankruptcy court granted the motion, and the
7 Office of the United States Trustee designated Cynthia Nelson (the "Trustee") to serve as
8 South Edge's trustee. (AER Tabs 10, 23, 24.)

9 After an unsuccessful appeal to this Court of the order appointing the Trustee,
10 JPMorgan and the Settling Builders (collectively the "Plan Proponents") entered into a Plan
11 Support Agreement. Pursuant to the Plan Support Agreement, the Plan Proponents agreed
12 to become joint proponents of a proposed plan of reorganization which would settle various
13 lawsuits among the interested parties as well as provide for an exit from bankruptcy. (AER
14 Tab 12.) More than 92% in dollar amount of the prepetition lenders consented to the Plan
15 Support Agreement. (Id. at ¶ 40.) The Trustee also consented to the Plan Support
16 Agreement. (Id. at ¶ 17.) The Plan Proponents thereafter filed the Joint Plan of
17 Reorganization Proposed by JPMorgan Chase Bank, N.A., as Administrative Agent Under
18 the Prepetition Credit Agreement, and the Settling Builders (the "Plan"). (AER Tab 2.)
19 Every secured and unsecured creditor who returned a ballot supported the Plan, as did seven
20 of South Edge's eight members. (AER Tab 8 at 8-9 ¶ 1.) Only Meritage filed objections to
21 the Plan and the proposed confirmation order. (AER Tabs 3-4, 19.) After holding a hearing
22 on Meritage's objections at which various witnesses testified, the bankruptcy court
23 overruled the objections and confirmed the Plan. (AER Tabs 6-8, 22.)

24 The Plan generally provides for the Settling Builders to contribute approximately
25 \$330 million to pay administrative expenses, secured claims, and general unsecured claims
26 against the estate, and to fund various expenses related to future development of Inspirada.

(AER Tab 8 at 21 ¶ 14.) In exchange, the prepetition lenders agreed to release the Settling Builders for amounts owed under the Credit Agreement and various guaranties by the Settling Builders and their parents, despite the fact that this would leave a deficiency of approximately \$47 million owed to the prepetition lenders under the Credit Agreement. (Id. at 10-11 ¶ 4 & n.1, 21 at ¶ 14.) Under the Plan, South Edge's assets are transferred to an Acquirer, a new entity formed by the Settling Builders. (Id. at 13 ¶ 6.) However, the South Edge estate retained some assets following confirmation, including certain litigation claims (the "Retained Actions"). (Id. at 14 ¶ 9.) The estate is to continue only for as long as is necessary to complete the administration of the estate, and South Edge will be dissolved upon final administration of the estate. (Id. at 13 ¶ 7.)

The Plan contains a provision through which the Settling Builders, rather than the prepetition lenders, assumed the risk of collecting on Meritage's Repayment Guaranty. Pursuant to section 3.4(f) of the Plan, the Settling Builders contributed over \$12 million to be placed in an escrow account. (AER Tab 2 at 328.) The amount deposited had to be "equal to the amount of the Meritage Repayment Guaranty liability as of the Effective Date." (Id.) Thereafter,

[a]ny Prepetition Lender . . . may elect . . . to assign to the Settling Builders a participation in the assigning Prepetition Lender's pro rata interest in the Meritage Repayment Guaranty claim under the Prepetition Credit Agreement, and in exchange for the assignment of such participation, the assigning Prepetition Lender's pro rata interest in the Meritage Repayment Guaranty Escrow shall be delivered to such Prepetition Lender on the Effective Date. To the extent that any portion of the Meritage Repayment Guaranty Escrow is not paid to electing Prepetition Lenders, then such amount . . . shall be disbursed to the Acquirer.

By electing to assign a participation in the Meritage Repayment Guaranty claim, the electing Prepetition Lender agrees to direct (consistent with the instructions of the Settling Builders) a sub-Agent . . . to pursue and, if instructed by the Settling Builders, settle the litigation concerning the Meritage Repayment Guaranty claim, which litigation shall be funded and directed solely by the Settling Builders, and the electing Prepetition Lenders shall be relieved of any obligation, financial or otherwise, including indemnity or expense reimbursement, with respect to any such litigation.

1 (Id.)

2 The Plan also contained a post-confirmation injunction as well as several releases
3 and exculpation clauses. Specifically at issue in this appeal are provisions which provide
4 for a post-confirmation injunction in section 8.3, and an exculpation clause in section 8.10.
5 Section 8.3 of the Plan provides:

6 Because the Debtor will be liquidating its Assets, the Debtor will not
7 receive a discharge under this Plan. However, until all remaining
8 Assets of the Reorganized Debtor and the Estate are administered, and
9 except as otherwise provided in this Plan or the Confirmation Order,
10 all Entities shall be barred from asserting against the Debtor or the
11 Reorganized Debtor, or their respective successors or property, any
other or further Claims, demands, debts, rights, Causes of Action,
liabilities, or Equity Interests based upon any act, omission, cause,
transaction, state of facts, or other activity of any kind or nature that
occurred prior to the Effective Date.

12 (Id. at 345.) However, pursuant to section 8.2, confirmation shall not “prejudice any party’s
13 ability to assert defenses to . . . Retained Actions,” except “that confirmation of the Plan
14 shall constitute a final determination by the Bankruptcy Court . . . that the proposing,
15 confirmation, and consummation of the Plan by each of the Plan Proponents was in good
16 faith and in accordance with law.” (Id.) The exculpation clause in section 8.10 provides:

17 None of (a) the Debtor, the Reorganized Debtor, or the Estate
18 Representative, (b) the Agent, (c) the Consenting Prepetition Lenders,
19 (d) the Settling Builders, (e) the TIP Loan Lenders, (f) the Trustee, and
20 (g) with respect to each of the foregoing Entities, their respective
21 directors, officers, employees, agents, representatives, shareholders,
22 partners, members, affiliates, attorneys, investment bankers,
23 restructuring consultants, and financial advisors in their capacities as
24 such (collectively, the “Exculpated Parties”), shall have or incur any
25 liability to any Entity for any act or omission in connection with,
26 relating to, or arising out of the Chapter 11 Case, the Disclosure
Statement, or any contract, instrument, release, or other agreement or
document entered into during the Chapter 11 Case or otherwise created
in connection with this Plan; provided, however, that nothing in this
Section 8.10 shall be construed to release or exculpate any Exculpated
Party from (i) its obligations set forth in this Plan, or (ii) willful
misconduct or gross negligence as determined by a Final Order.

26 (Id. at 350-51.)

1 In confirming the Plan, the bankruptcy court noted that South Edge was not
2 entitled to a discharge because it was liquidating. (AER Tab 8 at 26 ¶ 1.) However,
3 because some assets would remain with the estate following confirmation, including some
4 litigation claims, the injunction in section 8.3 served to implement the protections of the
5 automatic stay in 11 U.S.C. § 362, which would continue to apply to the estate assets post-
6 confirmation. (Id.) The bankruptcy court concluded the post-confirmation injunction
7 provisions were “of limited duration and protect only the Debtor and its Estate through the
8 completion of the liquidation of the Estate’s assets, at which time the Debtor will be
9 dissolved.” (Id. at 26-27 ¶ 1.)

10 The bankruptcy court found the exculpation clause and other releases in the Plan:

11 (i) are within the jurisdiction of the Court under 28 U.S.C. § 1334;
12 (ii) are integral elements of the transactions incorporated into the Plan;
13 (iii) confer material benefit on, and are in the best interest of, the Plan
14 Proponents, Debtor, the Estate, and Holders of Claims against the
15 Debtor, and are important to the overall objectives of the Plan; (iv) are
consistent with sections 105, 534, 1123, and 1141 and other applicable
provisions of the Bankruptcy Code; (v) are in exchange for valuable
consideration; and (vi) were properly noticed to Holders of Claims and
Equity Interests.

16 (Id. at 15 ¶ 12.) Specifically with respect to the exculpation clause in section 8.10, the
17 bankruptcy court found the clause:

18 establish[es] a standard of care within this Chapter 11 Case, and [is]
19 thus consistent with the rule in this Circuit that actions taken by parties
in furtherance of a federal bankruptcy case are governed exclusively by
federal bankruptcy law. Moreover, this Court has exclusive
20 jurisdiction over such actions, which may not be collaterally attacked
in a non-bankruptcy forum. There is a compelling need for Section
21 8.10 of the Plan, because the Meritage Parties already brought actions
against the Plan Proponents in non-bankruptcy forums based upon
22 actions they have taken in this Chapter 11 Case.

23 (Id. at 15 ¶ 13.)

24 The Confirmation Order also contained language to which Meritage objects with
25 respect to Meritage’s Repayment Guaranty. Specifically, Meritage challenges the
26 bankruptcy court’s ruling that the Plan’s “treatment of the [prepetition lenders secured] and

1 [unsecured deficiency] Claims will not affect the Meritage Parties' liability on their
2 Repayment, Completion, and Limited Guaranties, which are not being satisfied or released
3 under the Plan." (Id. at 33 ¶ 11.)

4 Meritage now appeals the bankruptcy court's Confirmation Order. JPMorgan
5 and the Settling Builders respond by moving to dismiss the appeal as equitably moot.
6 JPMorgan and the Settling Builders argue Meritage neither sought nor obtained a stay, and
7 the Plan since has been substantially consummated through a series of transactions,
8 including the payment of millions of dollars. JPMorgan and the Settling Builders contend
9 the Plan cannot be unwound, and Meritage cannot pick and choose the Plan provisions it
10 wants to strike where the Plan involves a multitude of complex, interrelated promises.
11 Meritage opposes the motion to dismiss, arguing that it was not required to obtain a stay so
12 long as the Court still may grant effective relief. Meritage contends the Court can do so
13 here because it may strike the offending provisions without affecting third party rights, and
14 there is no evidence of third party reliance or prejudice.

15 On the merits of the appeal, Meritage contends that a bankruptcy plan cannot
16 release the liability of nondebtor third parties over the objection of another interested party.
17 Meritage thus contends the Plan cannot release through the exculpation clause in section
18 8.10 Meritage's claims or defenses against JPMorgan in pending nonbankruptcy litigation.
19 According to Meritage, an exculpation clause cannot extend beyond the debtor, its estate,
20 and any estate fiduciaries. Meritage also contends there is no basis in the record to support
21 the bankruptcy court's factual findings with respect to the exculpation clause.

22 Additionally, Meritage challenges the post-confirmation injunction in section 8.3,
23 arguing it effectively grants South Edge a discharge to which it is not entitled under the
24 Bankruptcy Code. Meritage also contends it improperly cuts off Meritage's defenses
25 against any claim South Edge may assert against Meritage.

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1 Finally, Meritage argues the bankruptcy court erred by ruling that the Plan does
2 not affect or satisfy Meritage's liability under the Repayment Guaranty. Meritage contends
3 that issue is to be decided by nonbankruptcy courts which will address whether the Plan's
4 provisions affect or satisfy Meritage's Repayment Guaranty as a matter of state law.
5 Meritage further argues that if the bankruptcy court was going to decide this issue, it should
6 have provided Meritage with notice so Meritage would have an opportunity to address the
7 matter on the merits. According to Meritage, the bankruptcy court denied it was going to
8 make such a finding.

9 JPMorgan and the Settling Builders respond that the exculpation clause is
10 consistent with controlling authority which bars state law lawsuits based on actions taken in
11 a bankruptcy case. JPMorgan and the Settling Builders contend that federal preemption
12 principles support this position, because the bankruptcy court has exclusive jurisdiction
13 over the actions taken during and in furtherance of a bankruptcy proceeding. As to the
14 post-confirmation injunction in section 8.3, JPMorgan and the Settling Builders argue the
15 clause does nothing beyond stating the basic principle that South Edge's creditors have only
16 the rights set forth in the Plan, and such a provision is common where an estate will remain
17 open post-confirmation until certain estate assets are administered. They deny that section
18 8.3 cuts off defenses, such as setoffs, which Meritage may have in response to any claim
19 South Edge would bring against Meritage.

20 Finally, JPMorgan and the Settling Builders contend the bankruptcy court did not
21 err in ruling the Plan does not affect or satisfy Meritage's Repayment Guaranty because the
22 ruling was consistent with controlling authority that discharge of a debtor does not
23 discharge guarantors. Additionally, they argue the ruling is consistent with Meritage's
24 Repayment Guaranty, which states it is not reduced by other guarantors satisfying their
25 guaranty obligations. According to JPMorgan and the Settling Builders, the bankruptcy
26 court stated that it would not decide the merits of Meritage's obligations under the

1 Repayment Guaranty, such as whether Meritage's tender of performance in the spring of
 2 2008 satisfied its obligations under the Repayment Guaranty. However, the bankruptcy
 3 court made clear that it would decide the effect confirmation of the Plan would have on
 4 Meritage's Repayment Guaranty under bankruptcy law. Moreover, Appellants contend the
 5 ruling is correct factually, as Meritage paid nothing to settle its claim and could not expect a
 6 windfall from the Settling Builders' agreement to settle.

7 **II. MOTION TO DISMISS APPEAL (Doc. #17)**

8 Bankruptcy appeals become moot in two ways. First, an appeal becomes
 9 constitutionally moot when the Court cannot fashion effective relief. Focus Media, Inc. v.
 10 Nat'l Broad. Co., Inc., 378 F.3d 916, 922 (9th Cir. 2004). The "classic example" of
 11 constitutional mootness in a bankruptcy appeal "is a case in which the debtor has failed to
 12 seek a stay of foreclosure and the debtor's property has been sold. The transfer to a third
 13 party precludes meaningful relief." Baker & Drake, Inc. v. Pub. Serv. Comm'n, 35 F.3d
 14 1348, 1351 (9th Cir. 1994). This form of constitutional mootness has been codified in
 15 section 363(m) of the Bankruptcy Code.

16 An appeal also may become "equitably moot" when a "comprehensive change of
 17 circumstances may make it inequitable to consider the merits of the appeal and prevents [a
 18 court] from fashioning effective relief." Ederel Sport v. Gotcha Int'l L.P., 311 B.R. 250,
 19 254 (9th Cir. BAP 2004). To determine whether an appeal is equitably moot, the Court first
 20 looks at whether the appellant sought a stay, "for absent that a party has not fully pursued its
 21 rights." In re Thorpe Insulation Co., 677 F.3d 869, 881 (9th Cir. 2012). However, failure
 22 to seek or obtain a stay does not automatically result in equitable mootness. See id. at 881
 23 ("If Appellants here have presented appellate claims that can be remedied by some
 24 reasonable means without totally dislodging the § 524(g) plan, it would be inequitable to
 25 dismiss their appeal on equitable mootness grounds merely because the reorganization has
 26 proceeded."); In re Sylmar Plaza, L.P., 314 F.3d 1070, 1074 (9th Cir. 2002) (holding appeal

1 was not equitably moot even though the appellant did not seek a stay); In re Filtercorp, Inc.,
2 163 F.3d 570, 576-78 (9th Cir. 1998) (holding that appeal of summary judgment order was
3 not equitably moot despite the appellant's failure to seek or obtain a stay).

4 The Court also evaluates whether the plan has been substantially consummated.
5 Thorpe, 677 F.3d at 881. The Bankruptcy Code defines "substantial consummation" of a
6 plan as:

- 7 (1) transfer of all or substantially all of the property proposed by the
8 plan to be transferred;
9 (2) as assumption by the debtor or by the successor to the debtor under
10 the plan of the business or of the management of all or substantially all
11 of the property dealt with by the plan; and
12 (3) commencement of distribution under the plan.

13 11 U.S.C. § 1101(2). If "many intricate and involved transactions" called for by the plan
14 have been "so far implemented that it is impossible to fashion effective relief for all
15 concerned," an appeal may be equitably moot. In re Roberts Farms, Inc., 652 F.2d 793, 797
(9th Cir. 1981).

16 Additionally, the Court considers whether a remedy for the appellant affects third
17 parties not before the Court. Thorpe, 677 F.3d at 881. For this factor, "the question is not
18 whether it is possible to alter a plan such that no third party interests are affected, but
19 whether it is possible to do so in a way that does not affect third party interests to such an
20 extent that the change is inequitable." Id. at 882.

21 Finally, and "most importantly," the Court considers whether "the bankruptcy
22 court can fashion effective and equitable relief without completely knocking the props out
23 from under the plan and thereby creating an uncontrollable situation for the bankruptcy
24 court." Id. at 881, 883. In considering this factor, the Court should be mindful that where
25 the bankruptcy court could grant some relief, even if such relief is incomplete, the appeal is
26 not equitably moot. Id. at 883.

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1 The Court evaluates equitable mootness with respect to specific claims, not the
2 entire appeal. In re Filtercorp, Inc., 163 F.3d at 576-78 (holding that although appeal
3 regarding sale of assets was moot, appeal of summary judgment order that did not seek to
4 overturn asset sale was not equitably moot). The “party moving for dismissal on mootness
5 grounds bears a heavy burden.” Thorpe, 677 F.3d at 880 (quotation omitted).

6 Here, none of the issues in Meritage’s appeal are constitutionally or statutorily
7 moot because the Court can provide effective relief by modifying the Confirmation Order.
8 Although assets have been transferred to the Acquirer, none of the issues in Meritage’s
9 appeal seek to undo the asset transfer. All relate only to the potential impact of Plan
10 provisions on litigation claims or defenses in other actions between Meritage and South
11 Edge, the Settling Builders, or JPMorgan and the other prepetition lenders. Thus, the Court
12 could afford effective relief by modifying or striking the portions of the Plan and
13 Confirmation Order which Meritage challenges.

14 As to equitable mootness, Meritage failed to seek or obtain a stay. This factor
15 weighs in favor of finding all issues in Meritage’s appeal equitably moot, but it does not
16 require a mootness finding. As to the second factor, the Plan has been substantially
17 consummated. Substantially all of the property proposed by the Plan has been transferred
18 and a series of interrelated transactions have occurred. Specifically, the Settling Builders
19 have paid nearly \$340 million to JPMorgan and those funds have been distributed to the
20 prepetition lenders. (Decl. of William A. Austin in Support of Appellee’s Mot. for
21 Dismissal of Appeal (Doc. #18) at 13.) Administrative creditors of the estate have been
22 paid over \$10 million, including payments on LID Bond assessments, property taxes, and to
23 contractors working on the Inspirada project. (Id.) One of the builder members has been
24 paid over \$40 million on a related arbitration claim. (Id.) The Settling Builders paid \$1
25 million to fund the payment of unsecured creditors under the Plan. (Id.) Substantially all of
26 the estate’s assets have been transferred to the Acquirer. (Id.) Additionally, many related

1 lawsuits and claims have been settled in reliance of the Confirmation Order where no stay
2 was sought or obtained. (Id.) This factor therefore weighs in favor of finding all claims in
3 Meritage's appeal equitably moot.

4 However, the third factor weighs against a finding of equitable mootness. The
5 issues in Meritage's appeal would not affect the rights of third parties not before the Court.
6 Meritage does not seek to overturn confirmation or undo consummated transactions with
7 innocent third parties. For example, Meritage does not challenge provisions of the Plan
8 which provide for the payment of general unsecured creditors. Rather, it seeks modification
9 or elimination of discrete provisions which impact only the litigation positions of Meritage
10 vis-a-vis other parties who are before the Court—JPMorgan and the other prepetition
11 lenders, the Settling Builders, and South Edge. The Court therefore could fashion equitable
12 relief without unduly or inequitably impacting innocent third parties.

13 The final and most important factor also weighs against equitable mootness. The
14 issues in Meritage's appeal do not seek to overturn confirmation and are directed at discrete
15 provisions which can be modified without making an unmanageable situation for the
16 bankruptcy court. Altering these provisions in relation to Meritage's potential claims and
17 defenses in other litigation would not completely unravel an otherwise comprehensive
18 settlement of multi-million dollar intractable litigation that has spanned numerous cases in
19 multiple courts, and settlement has resulted in resumption of development at an otherwise
20 defunct development project. Although JPMorgan and the Settling Builders contend they
21 bargained for and thought they were attaining peace, they have obtained the peace they
22 bargained for with each other regardless of whether the Court finds Meritage's appeal
23 equitably moot. They could not have thought they were attaining peace as to Meritage, as
24 the nonbankruptcy litigation involving Meritage will proceed regardless of whether the
25 Court denies the appeal as equitably moot, denies the appeal on the merits, or grants
26 Meritage's appeal in whole or in part.

JPMorgan and the Settling Builders' concern that Meritage strategically decided not to seek a stay so that it could obtain the benefits of the Plan while seeking to strike or modify those provisions which are unfavorable to its position is not without force. However, on balance, the Court concludes JPMorgan and the Settling Builders have not met their heavy burden of showing it would be inequitable to consider the merits of Meritage's appeal where no third party rights are affected, the Court can fashion effective relief, and Meritage raises substantial arguments about the bankruptcy court's power to approve some of the provisions at issue in the appeal. The Court therefore will deny JPMorgan and the Settling Builders' Motion to Dismiss.

III. MERITAGE'S APPEAL

Meritage makes four main arguments on appeal. First, Meritage argues a bankruptcy court may not approve a nonconsensual release of nondebtor third party claims. Meritage contends the Plan and Confirmation Order therefore must be modified so that the exculpation clause in section 8.10 applies only to the debtor, the estate, and any estate fiduciaries. Second, Meritage argues there is no basis in the record for the bankruptcy court's factual findings in support of approving section 8.10. Third, Meritage challenges the authority to issue the post-confirmation injunction in section 8.3. Finally, Meritage challenges the bankruptcy court's ruling that Plan confirmation does not "affect" or "satisfy" Meritage's Repayment Guaranty.

The Court reviews de novo the bankruptcy court's conclusions of law, "including its interpretation of the Bankruptcy Code." In re Rains, 428 F.3d 893, 900 (9th Cir. 2005) (quotation omitted). The Court reviews the bankruptcy court's factual findings for clear error. Id. (quotation omitted); Fed. R. Bankr. P. 8013. The bankruptcy court's factual findings are clearly erroneous only if the findings "leave the definite and firm conviction" that the bankruptcy court made a mistake. In re Rains, 428 F.3d at 900 (quotation omitted). The Court reviews the bankruptcy court's decision to confirm a reorganization plan for an

1 abuse of discretion. In re Brothby, 303 B.R. 177, 184 (9th Cir. BAP 2003). “A bankruptcy
2 court abuses its discretion if it applies the law incorrectly or if it rests its decision on a
3 clearly erroneous finding of a material fact.” Id. The Court may affirm the bankruptcy
4 court’s decision “on any ground fairly supported by the record.” In re Warren, 568 F.3d
5 1113, 1116 (9th Cir. 2009).

6 **A. Exculpation Clause - Section 8.10**

7 Section 8.10 exculpates not only the debtor, but third party nondebtors, such as
8 JPMorgan and the Settling Builders, “for any act or omission in connection with, relating to,
9 or arising out of the Chapter 11 Case, the Disclosure Statement, or any contract, instrument,
10 release, or other agreement or document entered into during the Chapter 11 Case or
11 otherwise created in connection with this Plan.” (AER Tab 2 at 650-51.) However, no
12 party was released from obligations under the Plan or for willful misconduct or gross
13 negligence.

14 Meritage contends that under controlling authority, the bankruptcy court lacked
15 the power to confirm a plan that purports to release a nondebtor third party from liability
16 over the objection of another interested nondebtor third party. Meritage further contends
17 the Plan Proponents cannot obtain such a nonconsensual third party release through the use
18 of an exculpation clause, as such clauses are valid only if limited to the debtor, the estate,
19 and their fiduciaries.

20 JPMorgan and the Settling Builders respond that courts within this Circuit have
21 approved similar clauses. They also contend such clauses are consistent with federal
22 preemption principles because any challenges to conduct during or in relation to a
23 bankruptcy proceeding should be resolved by the bankruptcy court, rather than being
24 subject to collateral attack in a nonbankruptcy forum.

25 Some Circuits allow a bankruptcy plan to include a nonconsensual release of one
26 nondebtor’s claims against another nondebtor under certain circumstances. See Behrmann

1 v. Nat'l Heritage Found., 663 F.3d 704, 710 (4th Cir. 2011); In re Airadigm Commc'ns,
2 Inc., 519 F.3d 640, 657 (7th Cir. 2008); In re Metromedia Fiber Network, Inc., 416 F.3d
3 136, 141-42 (2d Cir. 2005); In re Dow Corning Corp., 280 F.3d 648, 656-58 (6th Cir.
4 2002). However, the United States Court of Appeals for the Ninth Circuit has prohibited
5 such releases as a matter of law, concluding that bankruptcy courts lack the power under the
6 Bankruptcy Code to discharge the liabilities of third parties who are not seeking bankruptcy
7 protection. See Stratosphere Litig. L.L.C. v. Grand Casinos, Inc., 298 F.3d 1137, 1143 (9th
8 Cir. 2002) (“[A] bankruptcy court cannot confirm a reorganization plan that discharges the
9 liabilities of a third party.”); In re Lowenschuss, 67 F.3d 1394, 1402 (9th Cir. 1995) (“This
10 court has repeatedly held, without exception, that [11 U.S.C.] § 524(e)[¹] precludes
11 bankruptcy courts from discharging the liabilities of non-debtors.”).² This Court is bound
12 by Ninth Circuit authority. Hart v. Massanari, 266 F.3d 1155, 1171 (9th Cir. 2001). The
13 Court therefore must reject a plan provision which purports to release third parties from
14 liability to a nonconsenting nondebtor. Whether the Ninth Circuit ought to reexamine its
15 prohibition on such releases is a matter for the Ninth Circuit, not this Court.

16 The question thus becomes whether the exculpation clause in section 8.10 of the
17 Plan improperly releases third parties liability or whether it merely sets the standard of care
18 in this bankruptcy proceeding which would preempt the assertion of any state law claims
19 which seek to impose a different standard of care. Under federal preemption principles, the
20 Bankruptcy Code “completely preempts state law tort causes of action for damages
21 predicated upon the filing of an involuntary bankruptcy petition.” In re Miles, 430 F.3d

22
23 ¹ Section 524(e) provides: “Except as provided in subsection (a)(3) of this section, discharge
24 of a debt of the debtor does not affect the liability of any other entity on, or the property of any other
entity for, such debt.”

25 ² See also In re Am. Hardwoods, Inc., 885 F.2d 621, 625-26 (9th Cir. 1989); Underhill v.
26 Royal, 769 F.2d 1426, 1432 (9th Cir. 1985), rejected on other grounds by Reves v. Ernst & Young, 494
U.S. 56 (1990).

1 1083, 1086, 1089-91 (9th Cir. 2005). For example, state law tort claims for malicious
 2 prosecution and abuse of process based on the filing of a bankruptcy petition, or for acts or
 3 omissions during a bankruptcy proceeding, are completely preempted. Id. at 1089-91; MSR
 4 Exploration, Ltd. v. Meridian Oil, Inc., 74 F.3d 910, 915-16 (9th Cir. 1996); Gonzales v.
 5 Parks, 830 F.2d 1033, 1035-36 (9th Cir. 1987).

6 State courts are not authorized to determine whether a person's claim
 7 for relief under a federal law, in a federal court, and within that court's
 8 exclusive jurisdiction, is an appropriate one. Such an exercise of
 9 authority would be inconsistent with and subvert the exclusive
 10 jurisdiction of the federal courts by allowing state courts to create their
 11 own standards as to when persons may properly seek relief in cases
 12 Congress has specifically precluded those courts from adjudicating.
 The ability collaterally to attack bankruptcy petitions in the state courts
 would also threaten the uniformity of federal bankruptcy law, a
 uniformity required by the Constitution.

12 MSR Exploration, 74 F.3d at 915 (quotation and citation omitted).

13 Moreover, Congress has chosen the remedies available for the frivolous filing of
 14 a bankruptcy petition, and "Congress' authorization of certain sanctions for the filing of
 15 frivolous bankruptcy petitions should be read as an implicit rejection of other penalties,
 16 including the kind of substantial damage awards that might be available in state court tort
 17 suits." Id. at 915-16 (quotation omitted). "[I]t is for Congress and the federal courts, not
 18 the state courts, to decide what incentives and penalties are appropriate for use in
 19 connection with the bankruptcy process and when those incentives or penalties shall be
 20 utilized." Id. at 916 (quotation omitted).

21 In conformity with these principles, some courts have found exculpation
 22 provisions similar to the one in section 8.10 confirmable because they "do[] not affect the
 23 liability of these parties, but rather states the standard of liability under the Code, and thus
 24 do[] not come within the meaning of § 524(e)." In re PWS Holding Corp., 228 F.3d 224,
 25 245 (3d Cir. 2000); see also In re WCI Cable, Inc., 282 B.R. 457, 476-77 (Bankr. D. Or.
 26 2002). In other words, the exculpation clauses do not affect a change in third party liability

1 to nondebtors because a state law tort claim for malicious prosecution or abuse of process
2 based on the filing of a bankruptcy petition does not exist, and thus there is no liability to
3 release. See In re Miles, 430 F.3d at 1091 (holding that “11 U.S.C. § 303(i) provides the
4 exclusive cause of action for damages predicated upon the filing of an involuntary
5 bankruptcy petition”).

6 In light of the above authorities, the exculpation provision in section 8.10 when
7 properly interpreted is within the bankruptcy court’s power because the bankruptcy court
8 has exclusive jurisdiction over the parties and their conduct in the bankruptcy proceedings.
9 Section 8.10 sets a standard of care to be applied in the bankruptcy proceeding—a matter
10 which lies within the bankruptcy court’s exclusive jurisdiction—and reiterates federal
11 preemption principles. Consequently, section 8.10 does not improperly release third party
12 nondebtors, such as JPMorgan and the Settling Builders, from liability arising out of these
13 Plan Proponents’ activities in relation to the bankruptcy proceeding because to the extent
14 any particular state law claim is preempted, no such state law claim exists. The exculpation
15 clause in section 8.10 therefore does not violate the Ninth Circuit’s prohibition on
16 nonconsensual third party releases through plan confirmation.

17 Whether any particular state law claim is barred by the exculpation clause or
18 federal preemption principles in general is not an issue before the Court in deciding whether
19 to confirm the Plan. The only question before the Court in this appeal is whether to affirm
20 or reverse the bankruptcy court’s confirmation of the Plan. Whether any particular state law
21 claim is preempted must be decided by the court presented with such a claim in the context
22 of the particular claim alleged, or, alternatively, by the bankruptcy court if relief is sought in
23 that forum. See In re McGhan, 288 F.3d 1172, 1181 (9th Cir. 2002); In re Birthing Fisheries,
24 Inc., 300 B.R. 489, 501 (9th Cir. BAP 2003).

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B. Factual Findings in Support of Section 8.10

Meritage contends that the bankruptcy court's factual findings in support of section 8.10 do not support the release of nonconsensual third party liability. Meritage contends there is no evidence the release in section 8.10 was integral to the Plan or was given in exchange for valuable consideration. According to Meritage, the Plan Support Agreement demonstrates the release was not integral to the Plan because the Plan Sponsors agreed they would proceed with the proposed Plan regardless of whether the bankruptcy court approved the proposed treatment of Meritage. JPMorgan and the Settling Builders respond that the bankruptcy court made sufficient factual findings and the record supports those findings.

As an initial matter, Meritage's objection regarding a lack of factual findings to support nonconsensual third party releases fails because, as discussed above, when properly interpreted section 8.10 does not release third parties from liability. Consequently, the bankruptcy court did not need to make any findings supporting nonconsensual third party releases. The bankruptcy court made sufficient factual findings to support the exculpation clause in section 8.10. The bankruptcy court found the Plan was proposed in good faith, provided the greatest opportunity to maximize the estate, was negotiated in good faith and at arms' length, achieved peace among most parties that had been involved in protracted litigation, and provided a means to restart an otherwise defunct development that affected not just the parties before the Court, but the community at large. (AER Tab 8 at 748-49.) The bankruptcy court also found the Plan Proponents made substantial contributions to the settlement, including the payment of millions of dollars by the Settling Builders, the prepetition lenders' consent to the Plan despite a deficiency of approximately \$47 million, and the resumption of development on the project. (*Id.* at 753.)

Specifically with respect to section 8.10, the bankruptcy court found the releases were within the court's jurisdiction and conferred a material benefit on the Plan Proponents,

1 the debtor, the estate, and creditors. (Id. at 747.) Additionally, the bankruptcy court found
2 the exculpation clause was important to the Plan's overall objectives and was in exchange
3 for valuable consideration. (Id.) The bankruptcy court further concluded section 8.10 was
4 consistent with controlling authority that exculpation clauses establish a standard of care in
5 bankruptcy proceedings and are supported by federal preemption principles. (Id.) These
6 findings are amply supported by the record. (AER Tabs 6-7, 13-15, 22.)

7 Meritage appears to challenge only the bankruptcy court's findings that the
8 exculpation clause was important to the Plan and was in exchange for valuable
9 consideration. Meritage relies on one provision of the Plan Support Agreement to make
10 this argument. Under the Plan Support Agreement, if Meritage did not become a Settling
11 Builder, the Plan would provide that Meritage's Guaranties were not released by the Plan.
12 Additionally, the Settling Builders would contribute funds equal to the amount of
13 Meritage's Repayment Guaranty to be placed in an escrow account through which the
14 Settling Builders could participate in any recovery against Meritage on the Repayment
15 Guaranty. The Plan Support Agreement stated that "the Confirmation Order shall be
16 acceptable to the Parties even if it does not enforce any or all" of the above provisions with
17 respect to the treatment of Meritage's Repayment Guaranty. (AER Tab 1 at 195-96.)
18 Based on this language, Meritage contends the exculpation provision was not important to
19 the Plan nor supported by consideration.

20 This language in the Plan Support Agreement had nothing to do with the
21 exculpation clause in section 8.10, however. It referred only to whether the Plan, by
22 operation of the bankruptcy laws, would release or satisfy Meritage's Repayment Guaranty
23 and whether the bankruptcy court would allow the use of the escrow fund and the Settling
24 Builders' participation in JPMorgan's claims against Meritage on the Repayment Guaranty.
25 The evidence which Meritage relies upon therefore does not show that the exculpation
26 clause in section 8.10 was not integral to the Plan or unsupported by consideration.

1 C. Post-Confirmation Injunction in Section 8.3

2 Meritage argues the post-confirmation injunction in section 8.3 is actually a
 3 discharge to which South Edge is not entitled under 11 U.S.C. § 1141(d)(3). Meritage
 4 contends section 8.3 improperly bars Meritage from asserting rights against the estate and
 5 its successors. JPMorgan and the Settling Builders respond that section 8.3 does not bar
 6 Meritage from asserting rights against South Edge or its estate. Rather, section 8.3 ensures
 7 that whatever rights or offsets Meritage asserts are administered through the Plan, and not
 8 through satellite litigation. JPMorgan and the Settling Builders contend the injunction is
 9 limited in scope and duration, and will cease upon dissolution of South Edge once all South
 10 Edge assets are administered.

11 South Edge was not entitled to a discharge under 11 U.S.C. § 1141(d)(3), and the
 12 bankruptcy court acknowledged that fact. Section 8.3 is not a de facto discharge and it does
 13 not bar Meritage from asserting any defenses or setoff rights against South Edge. Section
 14 8.2 specifically preserves those rights, and section 8.3 provides that a creditor's rights vis-a-
 15 vis South Edge are those set forth in the Plan. As the following colloquy during a hearing
 16 before the bankruptcy court explained,

17 COURT: [T]o the extent [Meritage has] any rights against the
 18 reorganized debtor those would be offset rights under 552 and 506
 secured claims.

19 SHAFFER: Exactly. They can't actually affirmatively collect
 20 anything, but their unsecured claim would, in essence, morph into a
 secured claim to the extent . . . of a valid offset.

21 (AER Tab 7 at 650.) In other words, to the extent Meritage still has claims against South
 22 Edge or the estate, those claims are contingent claims, and "[t]o the extent that those
 23 contingent claims become fixed, they would be treated as secure claims in Class . . . S-1."
 24 (*Id.* at 683-84, 706.) Such treatment is appropriate where, as here, the estate will continue
 25 for a period of time post-confirmation. See Hillis Motors, Inc. v. Hawaii Auto. Dealers'
 26 Ass'n, 997 F.2d 581, 588-90 (9th Cir. 1993).

D. Meritage's Repayment Guaranty

Meritage challenges language in the Confirmation Order that Plan confirmation did not “affect” or “satisfy” Meritage’s Repayment Guaranty. Meritage contends the bankruptcy court repeatedly indicated during the proceedings that it would not rule on the merits of any party’s arguments in nonbankruptcy litigation. Meritage contends the bankruptcy court nevertheless ruled Meritage’s obligations under the Repayment Guaranty were not affected or satisfied under the Plan. Meritage contends the bankruptcy court thereby made a conclusion of law which JPMorgan will use in nonbankruptcy litigation that the Plan does not satisfy Meritage’s obligations under state law.

JPMorgan and the Settling Builders respond that the bankruptcy court made clear it would resolve the issue of the effect of Plan confirmation on Meritage’s Repayment Guaranty under bankruptcy law, and that is what the bankruptcy court did. JPMorgan and the Settling Builders further contend that this result is consistent with controlling authority that the debtor’s discharge in bankruptcy does not discharge the liabilities of codebtors or guarantors, and it is consistent with the terms of Meritage’s Repayment Guaranty. JPMorgan and the Settling Builders argue this result is not only correct legally and factually, but was fair because Meritage contributed nothing to the settlement and thus cannot expect to have its own debts exonerated.

The bankruptcy court indicated on multiple occasions that it would not decide the merits of Meritage’s obligations under the Repayment Guaranty. (AER Tab 6 at 489-99, 494-95, 502-03.) However, the bankruptcy court made clear that it would decide the impact of confirmation on Meritage’s Repayment Guaranty under bankruptcy law. (*Id.* at 494-95, 502.) Its decision that confirmation did not affect or satisfy Meritage’s Repayment Guaranty is consistent with settled law that discharge of a debtor does not release codebtors or guarantors. 11 U.S.C. § 524(e); see also In re American Hardwoods, Inc., 885 F.2d at 625. The decision also is consistent with the expectations of the parties in this proceeding

1 where Meritage contributed nothing to the settlement.

2 The bankruptcy court did not purport to decide whether the transactions in the
3 Plan satisfied Meritage's Repayment Guaranty under nonbankruptcy law. (AER Tab 7 at
4 553.) As acknowledged at the hearing before the bankruptcy court, that question remains
5 for another forum to resolve:

6 ENGEL: There's no right intended anywhere in the plan or in the
7 related documents that intends that Meritage get its windfall
8 forgiveness without payment which is what they're seeking.

9 COURT: I appreciate it, and this may be more a question for Mr.
10 Shaffer than for you, but your position is, listen, if New York law
11 when it ultimately is brought to a court of competent jurisdiction says
12 that the procedures used today or proposed to be used today by the plan
proponents exonerates their guarantee so be it.

ENGEL: So be it.

COURT: Right. That's a risk the settling builders are taking.

ENGEL: That's a risk that they took. We think it's a small risk, but
that's the risk they took.

Court: Right.

13 (Id. at 555.) The bankruptcy court therefore properly resolved the issue within its exclusive
14 jurisdiction—the impact of Plan confirmation on Meritage's Repayment Guaranty under
15 bankruptcy law—and left for another forum to resolve the impact, if any, of the Plan
16 transactions on Meritage's Repayment Guaranty under applicable state law.

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E. Conclusion

The bankruptcy court acted within its power in setting a standard of care and reiterating federal preemption principles in section 8.10 of the Plan, and the bankruptcy court made sufficient factual findings in support of that ruling. The bankruptcy court also properly entered a post-confirmation injunction in section 8.3 which is of limited scope and duration to ensure estate assets are administered according to the Plan. Finally, the bankruptcy court gave notice of its intent to determine the issue of the Plan's impact on Meritage's Repayment Guaranty under bankruptcy law, and that decision was within the bankruptcy court's exclusive jurisdiction.

AFFIRMED.

DATED: August 8, 2012


PHILIP M. PRO
United States District Judge